EC Policy — Where Licensing Stands

Licensing is encouraged, but much more so between smaller than larger companies, policies show

BY HARRY CH. DONKERS*

As an American lawyer practicing in Paris and more than occasionally involved with European technology transfers, I find the questions which I was invited to address most intriguing. It will therefore be a pleasure and a privilege for me to deliver a personal opinion on the subject. I must caution you, however, that I have no inside information concerning the ways in which the policies of the European Communities are shaped, and therefore can base my opinion on the outward manifestations of such policies as a casual observer.

WHAT POLICY?

In order to home in on the answer to the questions posed, let us consider first what policy or policies are involved. We know that the main aim of the European Communities and of its administrative and legal structures and procedures is to establish and maintain a unified market of presently some 270 million consumers seeking to buy goods and services that are to circulate and compete freely within that market.

We also know that although progress has been made, the Common Market is still far from achieving that goal. Though tariff barriers have been dismantled between the member states, there are still many other forms of economic protectionism—some of them of recent development—which need to be overcome. To name only a few, we find today creeping neo-protectionism in such national regulatory schemes as environmental and consumer protection, product labeling and markings of origin, technical standards, price controls, procurement policies, import and export regulations and customs procedures, "buy-national," campaigns, credit limitations, and many other similar restrictions on the free circulation of goods or services.

The resurgence of such protectionist measures is largely attributed to the long-winded economic crisis which the European Community has been experiencing, as evidenced by its increasingly alarming rate of unemployment. The EEC is about to have 15 million persons looking for jobs. To combat unemployment the member countries are concentrating on national and regional solutions, whereas the European Commission is looking for solutions at the Community level. To coordinate the two lines of efforts, has been and continues to be a major challenge, and therefore a major goal of economic policy of the European Communities.

In the introduction to the EEC Commission's 13th and latest Report on Competition Policy, covering 1983, it is stated that:

> "... *The Commission's work of administering competition policy cannot be encapsulated by the sole objective of removing distortions caused by anticompetitive practices or state aids which are liable to interfere with interstate trade. Competition policy also contributes to improving the allocation of resources and raising the competitiveness of Community industry, and thanks to this greater competitiveness, secured largely by encouragement of research and development, to enabling the Community at length to overcome economic problems now facing it and in particular to combat structural unemployment. In this way competition policy can play its part, with other Community policies, in securing a lasting economic recovery.*"

It is interesting to note that the Commission considers it necessary for the European economic recovery that research and development be encouraged, and that it should be the aim of competition policy, along with other policies to bring about such encouragement.

Since we all know that without research and development there would be no licensing, and furthermore, that successful licensing is one of the greatest motivators for companies and individuals to engage in research and development, it seems to me logical to conclude that the Commission would also want to encourage licensing. Before I take up the question whether the Competition Policy encourages licensing in the EEC, I will briefly review what "other policies" are involved.

NEW TECHNOLOGIES

When we are thinking of increasing the competitiveness of the European Community through increased research and development activities, we are thinking of course of industrial innovation and new technologies. But it is not enough to create new technologies. It is also necessary to get them to the market, and to get them to the market *fast*.

The "third industrial revolution," which is being brought about by microelectronic technology, is characterized by speed of change at a dizzying exponential rate. By comparison to the situations in the previous two industrial revolutions—the ones brought about by the steam engine and the internal combustion engine—the advances in industrial innovation and their effects on society and its economic structures have become

**Attorney, Paris, France; paper presented at LES International Conference, Brussels, May 1984.*

increasingly unpredictable and less managable.

Most products of high technology today are said to have an average life of only three years. Considering the time it takes to bring a new product to the market, with average development time running about 18 months, and licensing of the technology involved requiring on the average also 18 months, it is evident that to be a successful competitor in the new technology fields, one must be able to be speedier than the average, which is very fast indeed. Hence, the constant pressure on industries to automate, and for the cost of capital equipment to come down to levels where it becomes cheaper than manual labor.

It has been predicted that this situation will become even more dramatic when we will be in the midst of the "fourth industrial revolution," based on biotechnology, which has already started. For Europe to hold its own in the "Bio-Society" of the 21st century, it will need to marshall all its resources to ride the waves of the information technology roller coaster of today's "Information Society." By the end of this century, more than 50% of the employed civil population is expected to be involved in the electronic handling of information.

Acutely aware of the problems and challenges now facing the European Community industrial sector, the Commission has determined to set a course for the stimulation and advance of industrial innovation, particularly in the areas of information technologies, telecommunications and biotechnologies, where Europe, once in the forefront of innovation, has fallen behind and become increasingly dependent on the United States and Japan.

Growth Potential

Because of the dynamic growth potential of the industries involved in information technology, the Commission's policy for industrial innovation has focused on that sector by proposing an ambitious project recently adopted by the Council of the European Communities and consisting of the European Strategic Programme for Research and Development in Information Technologies, more commonly known as "ESPRIT." The target of ESPRIT is to have the EEC's IT industries at least catch up with their U.S. and Japanese competitors within 10 years.

After an initial pilot phase to test the concept, which was started in 1983, the main program was formally adopted earlier this year, and funding for the first five years of the 10-year program was set at 750 million ECU's. This represents 50% of the estimated R&D budget, the other half of which will have to be provided on a matching basis by the EEC firms that will participate and be the main beneficiaries of this program. This also includes academic and institutional research centers that are intended to have a very important participation in ESPRIT.

Without going into details of the ESPRIT program, it can be said that it is the showcase of the EEC's policy for industrial development on a Community-wide basis. The projects to be covered will need to generally involve the cooperative efforts of firms from at least two member states.

Cooperation on a Community-market scale is needed because the individual projects to be covered, and particularly the commercial applications of any results obtained, will require levels of investment that cannot be amortized, to say nothing of being made profitable, on the basis of sales limited to national markets. The Commission is preparing similar programs with respect to the telecommunications and biotechnology industries.

An important aspect that needs to be stressed at this point is that the projects to be covered by the ESPRIT strategy are to involve only "pre-competitive" cooperation between unrelated firms. It is contemplated that the transition from R&D results to commercial applications development, production, and marketing would be generally accomplished on the basis of independent activities of the individual firms involved, as well as by other firms wishing to use the technology information generated by this program pursuant to licensing agreements.

Firms that participated in the R&D cooperation phase would have royalty-free licenses to individually exploit the results, and those that have not participated in the R&D would be licensed on reasonable royalty terms.

Thus, we see that, from the Commission's policy of stimulating EEC competitiveness through subsidized joint R&D, we fall into the application of the Commission's competition policy with regard to how this R&D is to be used.

COMPETITION POLICY AND LICENSING

Although the EEC Commission is genuinely concerned with the aspects of cooperative industrial innovation and is now working on a number of complementary R&D programs that are aimed at helping the process of channeling the results of basic or applied R&D projects to the marketplace, it is also facing a longstanding commitment toward a policy of free competition which generally frowns upon cooperation between competing or potentially-competing firms. Is the Commission about to be impaled on the horns of a dilemma of its own creation, or can its seemingly divergent policies in the area of technology be reconciled?

First, how does the Commission conceive the processes of industrial innovation? It has defined the term as follows:

> "*Industrial innovation is difficult to seize in orthodox economic terms. It principally means the introduction of new products, services, production methods or marketing and management techniques throughout the economy. Radical innovation creates new infant industries, incremental innovation revitalizes traditional branches. Innovation may be heavily research-based, and/or it may depend on ingenuity in production and marketing. It may depend on the spontaneity of small entrepreneurial units or be based on the economies of scale available only in large organizations.*"

This definition has the merit of showing that industrial innovation covers a wide spectrum of activities between initial product research and ultimate market exploitation.

To bring this definition well within today's competitive context, we must add the dimension of time. As mentioned, today's technological revolutions are dramatically reducing the time span for industrial innovation and generating rapid obsolescence. In programs such as ESPRIT, which will be highly reliant on licensing for dissemination of the technology that industrial firms will need to develop product applications, services and related marketing and management techniques, it will be extremely important that such licensing be carried out with corresponding speed and efficiency. Under the present situation of the EEC competition regulations with respect to the licensing of technology, can this be accomplished?

Furthermore, since the industrial innovation will be carried out over a wide range of companies, both large and small, and at different levels of production and marketing, licensing will likewise proliferate over various levels and in various directions, resulting in a cascading effect of interrelated contractual relationships throughout the European Community. That is assuming these programs will be carried out successfully.

What impediments can we foresee that could seriously put into question a successful outcome? In March 1983, the Advisory Committee on Industrial Research and Development (CORDI) sent a report to the Commission on its findings concerning the "principal obstacles which impede cooperation in R&D between firms and/or research centers in different member states of the Community." The CORDI report presented some interesting observations and conclusions which can be summarized as follows:

1. EC industrialists are convinced that the survival of European industry requires cooperation in R&D.

2. Companies are generally less reluctant to collaborate on pre-competitive research than on other types of R&D, but the closer the projects get to the marketplace the less they are interested in collaboration, unless there is precise agreement on how the fruits of their efforts are to be rewarded and shared.

3. The major efforts and expenditures do not occur in the earlier, pre-competitive phase of joint research, but rather in the later stages of production and marketing.

4. It is axiomatic for industry that the bulk of research cannot be uncoupled from its eventual exploitation.

5. Within the Community there are natural as well as artificial obstacles. Among the "natural" ones we have such matters as:

—Different languages, national laws, commercial and business practices.

—High communication costs.

—Geographic dispersion.

—Lack of organized information about companies.

—Low mobility among employees.

—Lack of technology-minded bankers, etc.

Among the "artificial" obstacles, one can think of such matters as:

—Various forms of intervention and control by local governments or other public sector institutions (procurement, financing, pricing, etc.)

—The absence of a unified EEC tax system favorable to transnational cooperation, particularly with respect to technology transfer.

—The relative scarcity of venture capital, particularly for financing R&D, and the absence of a united open market for trading in the securities of new-technology-based firms.

—*Most important*, the constraints imposed by the Community's Competition Law, the manner in which it is applied, and the uncertainties created by the regulatory provisions and their interpretation under case law.

As for the demotivating influences being exerted on industry by the natural and artificial barriers, it was the Working Party's conclusion that:

"... *Natural obstacles can have a strong demotivating effect on nondynamic companies. Dynamic companies have shown their ability to overcome these natural barriers; in their case, demotivation results essentially from Community Competition Law.*"

It seems evident that if the Commission expects to achieve effective cooperation at the pre-competitive R&D stage and a timely and efficient dissemination of the results to bring about the desired industrial and commercial exploitation it will have to implement a vigorous pro-patent and know-how licensing approach in the application of its competition policy.

Licensing is the only way that the ambitious EEC programs of industrial innovation in the new technologies can hope to bear the wished-for results within the timeframe available, and with the collaboration of large and small companies on a Community-wide basis. Yet, in contrast with this state of urgency and the sense of frustration expressed on the part of industry with regard to licensing under the European Community Competition Law, it seems to me paradoxical that it has taken so long for the Commission and the Council to adopt a long-awaited and much-debated draft regulation for a group exemption covering certain categories of exclusive patent licensing agreements.

THE DRAFT GROUP EXEMPTION REGULATION FOR EXCLUSIVE PATENT LICENSES

As I had the occasion to recount in an article I wrote for *Les Nouvelles* in 1979, the Commission's work on this group exemption goes back to at least 1973. After a number of preliminary drafts it finally published in 1979 its proposed regulation. Since 1979 this draft regulation has been the subject of ongoing debate, and its effective date, which had originally been set for January 1, 1980, was indefinitely postponed. This was done primarily on the grounds that the Commission wanted to wait for the decision of the European Court of Justice in the *Maize Seed* case addressing the question whether exclusivity grants in a license agreement are "pre-se" falling under the Article 85 (1) prohibition on restraints of trade in agreements between enterprises.

That decision was rendered on June 8, 1982, and we are still awaiting the Group Exemption Regulation nearly two years later. According to the Commission's latest Report on Competition Policy, there were at the end of last year, 4,138 cases pending before the Commission, of which 3,654 were pending notifications of agreements for 85(3) exemptions or negative clearances. All but 228 of those were already pending before 1983, many going back to the implementation of the Treaty of Rome. Most significantly, of all those pending notifications 62% concern patent licensing agreements.

It must be remembered that the Council's enabling decision giving authority to the Commission to issue group exemption regulations with respect to exclusive distribution agreements and exclusive license agreements was passed in 1965. Just two years later the Commission issued its group exemption Regulation 67/67 covering exclusive distribution agreements which was twice extended, and which since June 30, 1983 has been replaced by Regulation 1983/83 covering exclusive distribution agreements, and Regulation 1984/83 covering exclusive purchasing agreements.

Yet, during those same 16 years the Commission, in spite of the impressive backlog of notified license agreements, and numerous case decisions by both the Commission and the European Court of Justice, was not able to formulate an acceptable group exemption regulation applicable to exclusive patent licensing agreements. This long delay has been a source of uncertainty for industrialists and lawyers who have been trying to comprehend the direction of the Commission's competition policy with regard to the licensing of technology and the whole process of industrial innovation. As long as this uncertainty persists, companies in the EEC will continue to be apprehensive about the manner in which they can engage in any long-term licensing activities.

The Commission is obviously aware of this problem. It has announced in both its Twelfth and Thirteenth Reports on Competition Policy that it is continuing to work on a new version of the draft exemption regulation. The Commission has stated that its main objective for such a regulation is:

> ". . . To facilitate the transfer of new technology and to reinforce the competitivity of European industry, while ensuring that the principle of undistorted and workable competition is respected."

Whether the beginning and the end of that quotation can be truly reconciled in the context of the present European Community technology crisis will depend, in my opinion, to a large extent on the Commission's willingness to apply a realistic "rule-of-reason" approach.

In this respect, I consider the European Community at a disadvantage, as compared with the United States, in that a "rule-of-reason"-based exemption can only be granted by the Commission after notification of the license agreement, and therefore cannot be availed of in any other way, such as in arguments before a court in defense of a license agreement, if it was not previously notified to the Commission.

Disclosure

To many industrialists, notification of the license agreement is equated with embarassing disclosures of sensitive information, and above all with delays and uncertainty as to the outcome. Furthermore, when the exemption or negative clearance is finally granted, it may be subject to Commission-imposed limitations that can put undesirable constraints on the licensing relationship from a business point of view. The Commission is apparently trying to alleviate this problem. It is understood to be considering the inclusion in its new draft exemption regulation of an accelerated notification procedure. This would make it possible for patent license agreements which do not qualify for automatic exemption under the regulation, but which also do not contain any of the clauses prohibited by the regulation, to become automatically exempted under the regulation if the Commission does not formally object to such exemption within six months of the notification of such agreement. It is also understood that the Commission is definitely dropping the limitations as to the size of the companies involved in terms of their combined annual sales, or the size of the licensed territory in terms of total population, which were contained in its earlier drafts, so that the exemption can apply to both large and small or medium companies, as well as to licenses covering the entire European Community.

Another new feature is that the license agreements covered would no longer have to be predominantly based on patents, but could also include significant transfers of unpatented know-how, provided however that such know-how is still of a confidential nature, and that there are some patents included which are linked to the technology being transferred. Furthermore, there must be at least one such patent in effect for the duration of the license agreement.

The Commission refers to these types of licenses as "mixed-license agreements." The Commission is still not willing therefore to extend the scope of its proposed new regulation to purely know-how licenses. This, I feel, is being somewhat shortsighted. Inasmuch as new technologies are rapidly changing and resulting products quickly obsoleted, one could expect there will be increasing demands for know-how licenses covering technology for which there may be no time or insufficient certainty to obtain useful patent coverage. Thus, if speed in bridging the gap from laboratory to marketplace is to be one of the goals of the Commission's new policy on cooperative research and development, it should not continue to hesitate to include unpatented know-how license agreements in its improved clearance procedures.

The Commission has indicated that it still expects its new draft regulation to be published this year, and therefore to become effective on January 1, 1985. Whether it will drastically relieve the present apprehension that the EEC Competition law constitutes a major disincentive for licensing, remains to be seen. Though the *Maize Seed* case decision may have contributed to some softening of the Commission's outwardly critical attitude toward exclusive licensing agreements, I doubt that it will bring about any fundamental changes. If anything, the new regulation will probably set even stricter criteria with regard to the exercise of patent exclusivity rights under license agreements. For instance, a prohibition on the licensee to sell the licensed products in the territories of other licensees will not be exempted if it covers so-called "passive sales." These are sales resulting from the acceptance by the licensee of orders from purchasers located in such other territories that were not solicited by the licensee.

Furthermore, licensees could not be prevented under the new regulation from selling outside their territories into any other areas of the EEC that are not protected by parallel patents. In addition to this we have of course the need for total freedom on the part of third-party resellers to engage in parallel imports across licensed territories. It therefore seems unlikely that licensing in connection with cooperative research and development schemes, such as the ESPRIT program, will benefit measurably from the adoption of a new group exemption regulation on patent licensing as presently being proposed by the Commission.

It is perhaps for that reason that the Commission itself has proposed yet another group-exemption regulation which was published in January of this year and which is directed specifically to cooperative research and development agreements.

PROPOSED GROUP EXEMPTION REGULATION FOR COOPERATIVE RESEARCH AND DEVELOPMENT AGREEMENTS

The newly proposed regulation covers joint R&D agreements between two or more enterprises which can be actual or potential competitors. The regulation is not limited to just the pre-competitive research stage, but does provide for a continuation of the cooperation to the producing stage, but not as far as the joint marketing stage.

In the case of joint production, however, the exemption would be limited to cooperative production between small to medium companies with a combined total turnover not exceeding 500 million ECU's. The exemption of joint R&D agreements is open to cooperation between large and small companies alike with the limitation however that not more than one of the three most important, or potentially most important companies in the field covered by the joint research project may be involved at the time the agreement is signed. The same limitation applies with respect to cooperative production agreements derived from joint pre-competitive R&D projects.

The regulation spells out the types of restrictive clauses that may be contained in such agreements, depending on whether joint R&D or joint production is involved. In the event that the agreements involve parties who do not meet the qualifications or limitations I have just mentioned, or if they contain obligations or restrictive provisions which are not spelled out in the regulation, but which would as to their nature or effect generally be consistent with those included in the regulation, the Commission has provided for an accelerated notification procedure similar to the one I referred to earlier in connection with the new patent license exemption regulation.

The regulation would allow in the case of joint R&D agreements such matters as:

—Obligations on the part of the participants not to engage in competing R&D projects.

—Obligations to share all information concerning results obtained under the project between the various participants.

—Obligations to authorize all participants to individually exploit the results obtained from the joint R&D project, including the use of any technical know-how which was communicated as part of the project, whether or not these items are covered by patents or other industrial property rights.

—Restrictions on the participants from authorizing third parties to use the results of such joint R&D for a maximum of two years from the time when such results become exploitable.

In the case of joint-production agreements the regulation would allow such matters as:

—Obligations on each participant to limit production to only certain types of application for the purpose of specialization.

—Obligations on the participants for the use of jointly-owned or controlled production facilities, or to subcontract such production to designated third parties.

—Obligations on the participants not to enter into cooperation agreements with third parties which would compete with the purposes of the joint-production process.

—Obligations for the supply to the participants of the products covered by the production joint-venture, subject to compliance with minimum required quality specifications, and corresponding obligations to purchase such products from participants or from the joint-venture production facilities established or subcontracted by the participants, unless there are other sources offering better terms than those offered under the joint-production arrangement.

—Obligations to have the products distributed exclusively through participants, provided the users or resellers are free to purchase such products also from other sources.

The draft regulation also provides for certain additional permissible clauses such as for the payment of appropriate royalties between participants and the sharing of royalties from licenses granted to third parties, confidentiality and patenting provisions, after-sale servicing, etc. Finally, the draft regulation provides that the duration of a cooperative R&D agreement may not contain a fixed term in excess of five years, but it may continue thereafter subject to the right of termination by any party giving prior notice. Such prior notice may not exceed one year.

WHERE DO WE STAND?

It is already obvious from this brief review of the pending draft regulations covering patent licensing and cooperative R&D and production, that the two are not easily reconcilable, particularly with regard to large enterprises. Rather than to make things simple, these schemes appear, in spite of the best of intentions on the part of the Commission, to make life more complicated for those who engage in EEC licensing activities.

Perhaps the best news is that we now seem to be heading for a more efficient clearance procedure through the introduction of the "accelerated notification" concept. At least it will cut down on the waiting time, even if it does not necessarily add certainty as to the ultimate enforceability of restrictive provisions which are common to licensing and often economically justifiable.

Within the total context of industrial innovation we now have not only to keep in mind the existing group exemption regulations for exclusive distribution and purchase agreements, and the pending draft regulations on patent licensing and cooperative R&D agreements, we also should not overlook the potential relevancy to our licensing arrangements of some earlier regulations and official communciations of the Commission, namely:

—The group exemption regulation for certain specialization agreements (1972, as amended in 1977 and 1982).

—The Communication of July 29, 1968, concerning cooperative agreements, decisions and concerted practices between enterprises.

—The Communication of December 19, 1977, concerning agreements of minor importance.

—The Communication of December 18, 1978, concerning subcontracting agreements.

On this basis, it is my opinion that it is the European Community's policy to actively encourage rather than discourage licensing, particularly if it is carried on between small and medium enterprises. However, with regard to major licensing or industrial innovation projects, particularly when carried out between large companies, the encouragement is not very active, and maybe can even be characterized as extremely cautious if not altogether hesitant.

This hesitancy over time has become a source of discouragement, which appears to be at odds with the overall policy of the Commission to encourage cooperative research and development in the race for Europe to catch up with the United States and Japan in the new technologies and their industrial exploitations.

If Europe's economic survival were solely dependent on its competition policy with regard to licensing, I would be genuinely worried about the EEC's future.